ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	McClintock	Analyst:	Marion Mann DeJong	Bill Number:	AB 436
Related Bills:	AB 572 (1999/2000)	Telephone:	845-6979	Introduced Date:	02/12/1999
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Taxpayer's Rights Act/Burden of Proof on State or Local Agency

SUMMARY

This bill would add the Taxpayer's Rights Act to the Revenue and Taxation Code that would:

- Allow similarly situated taxpayers to file class claims for refund or class actions.
- Provide that the statute of limitations (SOL) for any legal action contesting the validity of a tax shall be at least three years.
- Provide that the doctrine of exhaustion of administrative remedies shall not be applicable in specified circumstances.
- Shift the burden of proof to taxing agencies in any legal action contesting the validity of any tax.
- Provide that if any statute, ordinance or resolution were determined in court to be facially invalid, any tax paid would be refunded to those who paid it.
- Award attorney's fees to any taxpayer who prevails in any legal action.

This bill provides that it would apply, notwithstanding any other law to the contrary, to all state and local governmental agencies in this state with respect to any tax. This analysis discusses the impact to Personal Income Tax (PIT) and Bank and Corporation Tax (B&CT) taxpayers and the Franchise Tax Board (FTB).

EFFECTIVE DATE

This bill would become effective on January 1, 2000.

SPECIFIC FINDINGS

Under federal law, taxpayers are required to keep certain records and may be requested by the Internal Revenue Service (IRS) to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on taxpayers' inability to substantiate items reflected on their income tax return or third party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable.

Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the IRS denies the protest, under the federal appeals system, the taxpayer may either: (1) appeal the deficiency assessment to the Tax Court, or (2) pay the assessment and file a claim for refund with the IRS.

Board Position:			Department Director	Date
______ S	______ NA	______ NP		
______ SA	______ O	______ NAR		
______ N	______ OUA	X PENDING	**Gerald Goldberg**	**3/22/1999**

A claim for refund must be filed by the taxpayer within three years of the filing of the return or within two years of the payment of tax, whichever period expires later. (If no return is filed the two-year limit applies.) A refund claim that is not filed within these time periods is rejected as untimely. Once the claim is denied (or if no action is taken within six months) by the IRS, the taxpayer may file suit for refund in U.S. District Court or the U.S. Court of Claims.

In these judicial actions, a rebuttable presumption exists that the IRS's determination of tax liability is correct. In Tax Court, taxpayers have the burden of proving that the IRS's action was incorrect. In U.S. District Court or the U.S. Claims Court, taxpayers must establish the merits of their claims. These conclusions are determined by a preponderance of the evidence. These actions are independent judicial determinations by a trial court upon evidence submitted by the parties. Federal rules of evidence apply. Both the taxpayer and the IRS can appeal adverse determinations of a trial court to an appropriate appellate court, except small claims division determinations, which cannot be appealed.

Under federal law, the burden of proof may shift to the IRS in any court proceeding for factual issues if the taxpayer introduces credible evidence with respect to factual issues, and the taxpayer meets certain conditions. This provision applies only to individuals and business entities that meet the $7 million net worth limitation for the awarding of costs and fees.

Under federal law, reasonable administrative and litigation costs may be awarded to a taxpayer who substantially prevails in an action by or against the United States in connection with the determination, collection, or refund of tax, interest, or penalty only when the position of the United States is not substantially justified. Only an individual whose net worth does not exceed $2 million is eligible for an award. Corporations or partnerships that have net worth not exceeding $7 million are eligible for an award. Awards and denials of attorney fees in administrative proceedings and court proceedings are subject to appeal.

Under current state law, all taxpayers may be requested by the FTB to furnish substantiation of the items reflected on their income tax returns, and certain taxpayers (i.e., water's-edge taxpayers) may be required to keep certain records. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

If the taxpayer disputes a proposed deficiency assessment or jeopardy assessment, the taxpayer may (1) protest the proposed deficiency assessment by filing a written protest or (2) petition for review of a jeopardy assessment by filing a written "petition for review" with the FTB. A petition for review of a jeopardy assessment is also considered a protest of the underlying deficiency assessment. The taxpayer may also pay the assessment and file a claim for refund.

A claim for refund must be filed within four years from the due date for filing the return (without regard to extensions) or one year from the date of payment of tax, whichever is later (special rules apply for claims relating to final federal determinations, bad debts, worthless securities or erroneous inclusion of recoveries).

A claim for refund must be in writing, signed by the taxpayer or the taxpayer's representative, and state the specific grounds upon which it is founded. A claim filed for or behalf of a class of taxpayers must be accompanied by written authorization from each taxpayer sought to be included in the class, be signed by each taxpayer (or their representative), and state the specific grounds on which the claim is founded.

If the claim is denied or no action is taken on the claim within six months, the taxpayer may proceed administratively to the Board of Equalization (BOE) or commence legal action (suit for refund) in superior court.

In the event of a final BOE decision adverse to the taxpayer on FTB's denial of a taxpayer's protest of a proposed deficiency, the taxpayer's recourse is to pay the amount due, file a claim for refund, and bring an action for refund against the state in superior court. In the event of a final BOE decision adverse to the taxpayer regarding FTB's denial of a claim for refund, the taxpayer's recourse is to bring a legal action for refund against the state in superior court. The FTB has no recourse in the event of a final BOE adverse to the FTB. Residency matters may be litigated in superior court prior to payment. In litigation, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund or in an action related to residence is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of establishing the merits of their claims by a preponderance of the evidence.

Under current state law, taxpayers may be reimbursed for costs/fees and expenses, including attorney fees, relating to tax matters before the BOE or court. For litigation the award may be made only to a prevailing party. However, for matters before the BOE, awards may be made if the BOE finds that the Franchise Tax Board has been unreasonable; and the taxpayer need not be the prevailing party. For both litigation and tax matters before the BOE, fees for representation are limited to attorney fees. For litigation, the allowable amount for attorney's fees is $110 per hour (adjusted for inflation); there is no statutory limit on attorney's fees for BOE hearings. However, awards of attorneys' fees for matters before the BOE are limited to $75. To be entitled to attorneys' fees for litigation, the taxpayer must exhaust all administrative remedies. At issue in awarding fees for litigation and for BOE hearings is whether FTB can establish that it was substantially justified in its position. FTB's position is presumed not to be substantially justified if the FTB did not follow its applicable published guidance (e.g. regulation, legal ruling, notice, information release, announcement, or any chief counsel ruling or determination letter).

Attorneys' fees awarded in court proceedings are appealable; however, there is no right to appeal decisions relating to attorneys' fees awarded in BOE hearings. Additionally, the taxpayer's ability to receive an award for fees is unaffected by net worth (federal law contains net worth limitations). For litigation, state law (Code of Civil Procedure Section 998) permits a party to receive costs and fees if the party makes a pre-trial settlement offer and the party obtains an equal or more favorable result at trial.

If any deduction, credit or exclusion under the Personal Income Tax Law or the Bank and Bank and Corporation Tax Law is finally adjudged discriminatory against a national banking association or is for any reason finally adjudged invalid or discriminatory, current state law limits the remedy available to a corporation by requiring the FTB to recompute the tax of favored taxpayers for the year in question by disallowing the deduction, credit, or exclusion to all taxpayers rather than refunding amounts to the disadvantaged parties.

This bill would add the Taxpayer's Rights Act to the Revenue and Taxation Code, which would:

- Allow similarly situated taxpayers to file class claims for refund or class actions.
- Provide that the SOL for any legal action contesting the validity of a tax shall be at least three years.
- Provide that the doctrine of exhaustion of administrative remedies shall not be applicable when the agency does not have the ability to grant relief or the taxpayer can demonstrate the administrative relief is unlikely to be successful.
- Shift the burden of proof to taxing agencies in any legal action contesting the validity of any tax.
- Provide that if any statute, ordinance or resolution were determined to be facially invalid rather than invalid as applied to a particular taxpayer, the agency would be obligated to return all proceeds of the tax to those who paid it, not just the parties to the lawsuit.
- Award attorneys' fees to any taxpayer who prevails in any legal action.

Constitutional Consideration

Article III, Section 3.5 of the California Constitution provides that an administrative agency does not have the power:

(a) to declare a statute unenforceable, or refuse to enforce a statute on the basis of it being unconstitutional unless an appellate court has made a determination that the statute is constitutional

(b) to declare a statute unconstitutional

(c) to declare a statute unenforceable, or to refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute, unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

Policy Considerations

This bill would raise the following policy considerations.

- The burden of proof provision of this bill does not conform to the federal law. This bill does not: (1) limit the burden of proof shift to factual issues, (2) limit the burden of proof shift to smaller taxpayers, (3) require taxpayers to introduce credible evidence with respect to factual issues, keep records or cooperate with FTB, and (4) limit the provision to court proceedings arising in connection with "examinations" commencing after the date of enactment.

- Allowing taxpayers to circumvent administrative remedies could increase the number of tax cases in the court system.

- The affirmative obligation to return all proceeds of a facially invalid tax to all taxpayers that paid the tax irrespective of whether the taxpayers were parties to the action adjudicating the tax as facially invalid could be inconsistent with the requirements of existing law to increase the tax of taxpayers “favored” by the facially invalid tax.

Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- The provisions of this bill are unclear and department staff does not fully understand the author's intent. For example, the bill provides that the cause of action shall accrue at the time of payment or delinquency of the tax and not the enactment of the statute, ordinance, or resolution imposing the tax. Generally, a cause of action occurs after payment of the tax and request for refund has been denied.

- Many terms and phrases are not defined (e.g., validity of any tax, legal action, facially invalid). If read in the broadest possible sense, some of these undefined terms could have a significant impact on the administration of FTB’s programs. Unclear and undefined terms can lead to disputes between taxpayers and the department.

- Some provisions of this bill directly conflict with provisions in the PIT and B&CT laws (e.g., period for filing a claim for refund, attorneys’ fees, remedies for a discriminatory tax)and would override those laws. As to other provisions (class actions, exhaustion of administrative remedies), there is no direct conflict with existing laws, but it is unclear how related provisions should be applied.

- The bill would require the department to return all proceeds of a tax if the tax were facially invalid. Depending on the nature of the item and how it is reported on the tax return, the department may have difficulty identifying all impacted taxpayers. Further, it is unclear whether this provision would apply only to all tax years with an open statute.

FISCAL IMPACT

Departmental Costs

The department’s costs to administer this bill cannot be determined until implementation concerns have been resolved.

Tax Revenue Estimate

The revenue of this bill cannot be determined until the implementation concerns have been resolved.

BOARD POSITION

Pending.